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The quest for means whereby taxpayers may realize income that will be subjected to tax only at capital gain rates is a never ending one. To the taxpayer who already has large amounts of ordinary income, there is little incentive for realizing additional income other than that which will be capital gains. But even to the lower income taxpayer capital gains are important because only half the gain will be subject to income tax until his income reaches an amount sufficient to make applicable the alternative tax computation by which it will be taxed at the present maximum rate of twenty-five per cent.

Our tax law and regulations contain numerous provisions relating to capital gains and losses. Obviously our time tonight will not permit a discussion of all of those provisions. For our discussion, I have selected some of those pertaining to real estate, timber, and involuntary conversions.

Of course, each one of these subjects, in itself, provides enough material for much more time than we are going to devote to all three here tonight. However, this paper is confined to a discussion of these subjects only as they are affected by the gain and loss provisions of the Code and Regulations; it does not include a discussion of the multitude of other tax problems connected therewith.

REAL ESTATE

First let us take a look at some of the tax considerations involved in the disposition of real estate. To begin with we might say that, as to tax consequences upon disposition, real estate falls into four principal categories, held or used as follows:

- As a personal residence
- In a trade or business
- Primarily for sale to customers
- For investment

The general rule pertaining to the sale of a personal residence is that any gain realized is taxed as capital gain and any loss suffered is not recognized for tax purposes. However, Internal Revenue Code Section 1034 provides that if the taxpayer purchases property for his new residence within one year before or after the sale of his old residence or commences construction on a new residence within one year after the sale of his old residence and occupies it within eighteen months from such date, then any gain realized shall be recognized only to the extent that the adjusted sales price of the old exceeds the purchase price of the new. It is to be noted that so-called "fixing up" expenses are deductible only in determining the adjusted sales price and that such expenses are not taken into account in computing the amount realized from the sale of the old residence. If more than one new residence is purchased or constructed and occupied within the prescribed period then only the purchase of the last one is considered in the application of Section 1034. This section is not elective but instead shall apply to all sales of residences within its purview.

Subsequent disposal of a former personal residence that has been converted to income-producing property may present some tax problems. Any gain realized will, of course, be taxed and presumably any loss sustained, as determined under applicable basis provisions, will be deductible. But will those gains and losses come within the provisions of Section 1231 or will their tax consequences be governed by the capital gain and loss provisions relating to capital assets as defined in Section 1221? Is the renting of a former residence now converted to income-producing property considered to be a business or not? For some time the Tax Court said "yes," it was a business. However, recent Court decisions have been to the contrary in holding it not to be a business; therefore, any loss sustained is a capital loss.

Real estate used in a trade or business is accorded special favorable treatment by Section 1231, which provides that if, during the taxable year, the recognized gains on sales or exchanges of property used in a trade or business and held for more than six months exceed the recognized losses from such sales or exchanges, the net gain is considered to be a gain from the sale or exchange of a capital asset. If there is a net loss from such sales and exchanges, it is deductible in full. Section 1231 also provides that gains and losses from involuntary conversions, which we will discuss a little later, will be considered in determining the net gain or loss under that section.

Real estate held primarily for sale to customers does not present any particular tax problem. Such real estate is not a capital asset; therefore any gain or loss upon its sale or exchange is ordinary income or loss. Taxpayers holding real estate primarily for sale to customers are generally referred to as dealers. The most difficult tax problem confronting tax practitioners and their real estate investor clients who have not yet been classified as dealers is how to keep them out of that category. This paper does not comprehend a discussion of the numerous considerations concerned with determining whether a taxpayer is a dealer or an investor. Suffice it to say that in our tax planning concerning the disposition of real estate, we should exhibit the utmost care to avoid having this stigma placed upon our investor clients.

Let us consider now some of the problems confronting the investor interested in disposing of some of his unimproved real estate through subdividing. Prior to the enactment of the 1954 Code, subdivided real estate, regardless of how it was acquired, was usually considered as held primarily for sale to customers, and therefore any gain realized was taxable as ordinary income. Consequently, in those cases where a taxpayer held unimproved real estate for investment and decided to subdivide and then sell, he usually became a dealer for tax purposes. Section 1237 of the 1954 Code offers some relief for this situation in that it provides for capital gains treatment of a portion of such sales under certain conditions. As originally enacted, this section applied only to individuals; however, an amendment effective January 1, 1955 made it applicable to corporations under certain limited conditions.

The basic requirements for the application of Section 1237 as to individuals are as follows:

1. Taxpayer cannot have held the tract, or any lot or parcel thereof, at any time previous to the sale primarily for sale to customers in the ordinary course of business, and cannot in the same taxable year in which the sale occurs have held any other real estate for sale to customers.
2. No substantial improvement that substantially enhances the value of the lot or parcel sold can be made while held by the taxpayer or can be made pursuant to a contract of sale entered into between the taxpayer and the buyer.
3. The lot or parcel must have been held by the taxpayer for at least five years unless acquired by inheritance or devise, in

which case other provisions of the Code relating to the holding period are applicable. In this connection, the regulations provide that neither the survivor's one-half of community property, nor property acquired by survivorship in a joint tenancy is property acquired by inheritance or devise. The holding period for the survivor begins on the date the property was originally acquired.

Corporations, in order to qualify for Section 1237 benefits must meet, in addition to those applicable to individuals, the following requirements:

1. No shareholder can be, directly or indirectly, a real estate dealer.
2. The property subdivided must be:
   a. Acquired through the foreclosure of a lien thereon which secured the payment of an indebtedness to the taxpayer, or
   b. Acquired through the foreclosure of a lien thereon which secured the payment of an indebtedness to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of its stock and other consideration, or
   c. Adjacent to property of either of the two types just described if eighty per cent of the real property owned by the taxpayer is property so acquired by foreclosure.

A tract for purposes of Section 1237 means a single piece of real property, except that two or more pieces of real property shall be considered a tract if at any time they were contiguous in the hands of the taxpayer or if they would be contiguous except for the separation by property such as a road, street, railroad, stream, or similar property. If, following the sale or exchange of any lot or parcel from a tract of real property, no further sales or exchanges of any other lots or parcels from the remainder of such tract are made for a period of five years, then the remainder shall be deemed a tract.

For the purposes of determining whether substantial improvements that substantially enhance the value of the lot or parcel sold have been made by the taxpayer, an improvement shall be deemed to have been made by the taxpayer if it was made by any of the following:

- The taxpayer or members of his family, as defined in Section 267 (c) (4)
- A corporation controlled by the taxpayer

- A partnership in which taxpayer is a partner
- A lessee if the improvement constitutes income to the taxpayer
- Federal, state, or local government, or political subdivision thereof if the improvement constitutes an addition to basis for the taxpayer

The Regulations contain a number of provisions as to improvements to the property and their relation to its value. In order for improvements to preclude the use of Section 1237 they must substantially enhance the value of each lot sold. Provisions relating thereto are as follows:

- Only the increase in value attributable to the improvements is to be considered. Other changes in market price not arising from improvements are not to be considered.
- If improvements increase the value by ten per cent or less they are not considered substantial. If the increase in value is more than ten per cent then all relevant factors will be considered in determining if the increase is substantial.
- Improvements may increase the value of some lots in a tract without equally affecting other lots in the same tract. In such a situation only those lots whose value was substantially increased are ineligible for the benefits of Section 1237.

Types of improvements considered substantial are shopping centers, other commercial or residential buildings, hard surface roads, and sewer, water, gas, or electric lines. Some of those not considered as substantial are temporary field office, surveying, filling, draining, leveling, and clearing, and minimum all-weather access roads.

Special provisions are made for the availability of the benefits of Section 1237, whether or not substantial improvements have been made, under the following conditions:

- Taxpayer has held the property for at least ten years, which holding period requirement, incidentally, applies even to inherited property.
- The improvements consist of building or installation of water, sewer, or draining facilities, or roads.
- The taxpayer convinces the Internal Revenue Service that, without the improvements, the lots sold would not have brought the prevailing local price for similar building sites.
- The taxpayer elects not to adjust the basis of the property or deduct any cost or expense on account of the improvement.

• The provisions of satisfying the Internal Revenue Service and of making the basis election do not apply, however, to property acquired by foreclosure of a lien.

So far in our discussion of Section 1237 we have considered only the factors concerned with ascertaining if a taxpayer qualifies for the benefits of this section. Now let us take a look at the tax consequences if Section 1237 does apply. Until the year in which the sixth lot from each tract is sold all gain is capital gain. Although the section is applicable to sales made by individuals in years after 1953 and by corporations in years after 1954, all pre-1954 sales will be counted in determining the first five lots sold from each tract. If as much as five years elapse between any sales, the taxpayer can start the count of five sales over again.

In the year in which the sale of the sixth lot occurs, an amount up to five per cent of the selling price is ordinary income and the rest is capital gain. The expenses of sale are first deducted from the ordinary income derived from the sales and any remainder is treated as reducing the amount realized from the sale or exchange. None of the expenses of sale can be deducted as ordinary business expenses from other income.

We can see from the foregoing that Section 1237 is very technical. Although our lawmakers apparently intended to permit the real estate investor to subdivide and engage in some sales activity without his gains being taxed at ordinary income rates, the application of the section is obviously limited. It has been suggested that maybe the better course would be for the investor to engage a broker on a commission basis for disposition of his real estate.

TIMBER

Let us consider now the gain and loss provisions relating to timber. Prior to 1944 the Code did not contain any express statutory provisions relating to the character of gain or loss from the disposal of timber. Consequently, there was much litigation involving the tax consequences arising therefrom. In 1944 Section 117 (k) was enacted in the Revenue Act of 1943 over the strong protest and veto of President Roosevelt. Section 631 in the 1954 Code is substantially the same as Section 117 (k) except that some explanatory wording has been added thereto. Christmas trees were brought within its provisions by the addition of the words that the term "timber" includes evergreen trees more than six years old at the time severed from the roots and sold for ornamental purposes. There is, however, one significant change in the 1954 Code provision, and that is, with respect to disposal of timber with a retained economic interest, the date of disposal of such timber shall be deemed to be the date it is cut, but if payment is made to the owner under the contract before the timber is cut, the owner may elect to treat the date of such payment as the date of disposal of the timber. Under the 1939 Code the date of disposal of timber was deemed to be the date the contract for disposal was entered into.

In enacting the present provisions into the Code it was the apparent intent of Congress to: (1) stimulate the development of forest resources by providing taxpayers incentive for improving their timber holdings, (2) remedy the inequity of taxing the increase in value arising over a long period of time as ordinary income in the year of disposal, (3) and place those who cut their own timber or disposed of it under a cutting contract in the same tax position as the owner who sold his timber properties outright. Section 631 itself does not provide that income within its scope is capital gain; it merely states that such income shall be considered as income from a sale or exchange of timber. The tax consequences are governed by Section 1231 since timber is classed as property used in a trade or business.

Capital gains in the case of standing timber may arise in three different ways as follows:

- Outright sale of standing timber held for more than six months in which no economic interest is retained
- Cutting of timber by the owner or by the owner of a cutting contract
- Disposal under a cutting contract

Of course gains from sales of timber held by a taxpayer in the capacity of a dealer or held by any taxpayer for six months or less are considered ordinary income.

Gain or loss resulting from the sale of standing timber is simply measured by the difference between the sales price and its adjusted basis for depletion.

Under Section 631 (a) a taxpayer, who cuts his own timber for sale or for use in his trade or business, may elect, as to timber held for a period of more than six months before the beginning of the taxable year, to have such cutting considered as a sale or exchange of such timber during the taxable year. If the election is made, gain or loss is measured by the difference between the fair market value of the timber as of the first day of the taxable year in which it is cut and the adjusted basis for depletion. This fair market value is then considered to be the cost of the cut timber to the taxpayer for all other purposes for which cost is a necessary factor. The election is available to the owner of the timber or to one who has a contract right to cut the timber. The election is binding for all subsequent years and shall apply to all timber owned by the taxpayer or which the taxpayer has a contract to cut. The Secretary of the Treasury may, upon showing of undue hardship, permit the taxpayer to revoke his election; however, if such permission is obtained the taxpayer cannot subsequently make the election again without the consent of the Secretary.

Determination of the market value of the timber as of the beginning of the year in which it is cut can present many problems. Theoretically such market value is the amount for which it could have been sold before cutting. There are numerous factors to be considered in the determination, however, but this paper does not comprehend a discussion of that particular problem.

While the provisions of Section 631 (a) relating to capital gain treatment of timber cut are elective, the provisions of Section 631 (b) relating to disposal of timber with a retained economic interest are mandatory. When timber held for more than six months under any form of ownership, including a sublease or a contract to cut timber, is disposed of through a cutting contract under which an economic interest is retained, this section treats the timber as a Section 1231 asset. As previously mentioned, the date of disposal shall be deemed to be the date the timber is cut, but if payment is made to the owner under the contract before such timber is cut, the owner may elect to treat the date of the payment as the date of disposal.

Fundamentally a cutting contract provides the basis for payments for timber, measured by the amount of timber cut, which payments are comparable to bonus and royalty payments made under an oil and gas lease. Any advance royalties and bonuses received under contracts providing that such payments are to be applied for timber subsequently cut are treated as realized from the sale of timber if the timber paid for is cut more than six months after its acquisition. If any part of the timber cut under the contract has not been held for more than six months, the advance payment must be apportioned, according to relative quantities, between such timber and that held for more than six months. Gain attributable to that held for not more than six months shall be taxed as ordinary income. In the event the contract expires before all the timber paid for has been cut, the owner must treat that portion of the payments attributable to the uncut timber as ordinary income. This may necessitate the filing of an amended return.

INVOLUNTARY CONVERSIONS

Let us turn our attention now to some of the tax considerations related to a number of situations coming under the general heading of involuntary conversions. The Regulations state that an involuntary conversion may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. It may be a conversion into similar property or into money or into dissimilar property.

After an involuntary conversion has occurred, what is the tax consequence of the gain or loss resulting therefrom? Section 1033 provides for the nonrecognition of gain under certain specific circumstances as follows:

1. When property is involuntarily or compulsorily converted into property similar or related in service or use, no gain shall be recognized. This provision is mandatory and not elective on the part of the taxpayer.
2. When property is involuntarily or compulsorily converted into money or into dissimilar property, the taxpayer is given an election to avoid the recognition of gain. If the taxpayer, within the prescribed period of time after conversion, purchases other property similar or related in service or use to the property converted, or purchases stock in the acquisition of control of a corporation owning such other property, then the taxpayer may elect to have the gain recognized only to the extent that the amount realized upon the conversion exceeds the cost of the other property or stock. "Control" for the purposes of this means the ownership of at least eighty per cent of the voting stock and at least eighty per

cent of the total number of shares of all other classes of stock of the corporation. In order for the taxpayer to qualify for the benefits of this section the converted property must be replaced within a period which begins on the earlier of the date of the disposition of the converted property or the date of the threat or imminence of requisition or condemnation of the converted property and ends one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, unless an extension of time is granted by the Commissioner.

So much for the nonrecognition features of involuntary conversions. Let us consider now some of the provisions applicable to the recognition of gain or loss. The tax consequences depend first upon the nature of the converted property. Involuntary conversion does not bring within the provisions of Section 1231 that which would otherwise be ordinary income or loss or short-term capital gain or loss had the converted property been disposed of on the date of conversion by some means other than conversion. However, if the property converted was either property used in a trade or business and held for over six months or a capital asset which was held for over six months the tax consequences are governed by the provisions of Section 1231, which provides that such gains or losses will be added to gains and losses arising from the sale or exchange of property used in a trade or business in determining the net gain or loss under that section.

A condemnation of property is an involuntary conversion. Additional tax problems may arise in connection therewith. The first determination to make is how much of the proceeds is consideration for the property condemned and how much is consideration for something else. If all is for the property condemned, there are no additional problems; all the gain or loss comes within the provisions of Section 1231.

Suppose, however, that a portion of the proceeds represents severance damages or that there are some special assessments to consider. By severance damage we mean, of course, resulting damage to the surrounding property which is not condemned. Consideration for such damage is not treated as consideration for the property condemned, but, instead, is applied against the basis of the damaged property. If the amount paid for the damage exceeds the basis of the property, then that amount is treated as gain. It should be pointed out that in all proceedings embracing severance damages, the amount of the gross proceeds applicable thereto should be specified; otherwise, the total consideration might be treated as having been received for the property condemned.

Special assessments sometimes arise in connection with condemnations. This occurs when the value of the property surrounding the condemned property is considered to be enhanced by the changes in or improvements to the condemned property. Special assessments are treated as a reduction of the gross consideration, including severance damages. If the special assessments exceed the consideration for severance damages the excess is treated as a reduction of the consideration for the condemned property. If the consideration for severance damages, however, exceeds the special assessment, such consideration is first offset against the special assessment and the remainder is then applied against the basis of the surrounding property not condemned.

Legal fees and other expenses incurred in connection with condemnation proceedings should be deducted from the total consideration in determining gain or loss.

Casualty losses are another type of involuntary conversion which present their own peculiar problems. Included in that category are losses from fire, storm, shipwreck, vehicular accidents, and similar losses to property by a sudden, unexpected, or unusual event. The nature of the event sometimes makes it very difficult to establish that there has been a casualty loss within the meaning of our tax law. There has been considerable litigation in this connection.

A number of problems may arise in connection with the ascertainment of the amount of loss suffered. We, however, will not go into a discussion of that subject, but, instead, will confine our thoughts to the gain and loss provisions relating thereto. If a gain arises in connection with a casualty loss the general rules relating to the recognition or nonrecognition in respect to involuntary conversions apply. If there is a loss the tax consequences depend upon whether the property destroyed or damaged was business property or non-business property.

Generally a casualty loss of non-business property is deductible only if the taxpayer itemizes his deductions. However, if the property was held for more than six months and the taxpayer has a net gain from sales and exchanges of Section 1231 property which is greater than the casualty loss, the casualty loss is deducted therefrom on Schedule D regardless of whether the taxpayer itemizes his deductions.

The tax consequences of casualty losses to business property and capital assets held for more than six months and held for the production of income depend upon whether such property was insured. If there is any insurance recovery the net loss comes within the provisions of Section 1231. An amendment to the Code effective for tax years beginning after 1957 grants an ordinary loss deduction for casualty losses to such property if the property is completely uninsured.